

Estimating Bankruptcy Using Neural Networks Trained with Hidden Layer Learning Vector Quantization

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Abstract

The Hidden Layer Learning Vector Quantization (HLVQ), a recent algorithm for training neural networks, is used to correct the output of traditional MultiLayer Preceptrons (MLP) in estimating the probability of company bankruptcy. It is shown that this method improves the results of traditional neural networks and outperforms substantially the discriminant analysis in predicting one-year advance bankruptcy. We also studied the effect of using unbalanced samples of healthy and bankrupted firms.

The database used was Diane, which contains financial accounts of French firms. The sample is composed of all 583 industrial bankruptcies found in the database with more than 35 employees, that occurred in the 1999-2000 period. For the classification models we considered 30 financial ratios published by Coface¹ available from Diane database, and additionally the Beaver (1966) ratio of Cash Earnings to Total Debt, the 5 ratios of Altman (1968) used in his Z-model and the size of the firms measured by the logarithm of sales. Attention was given to variable selection, data pre-processing and feature selection to reduce the dimensionality of the problem.

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¹ Coface is a credit risk provider in France that offers the Conan-Holder bankruptcy score, a score based on a discriminant analysis developed by the authors (CONAN D., HOLDER M., 1979).

1. Introduction

Financial distress prediction is of extreme importance for banks, insurance firms, creditors, and investors. The problem is stated as follows: given a set of parameters, mainly of financial nature, which describes the situation of a company over a given period, and eventually some macro-economic indicators, how can we predict if a company may become bankrupt during the following year?

Since the work of Beaver (1967) and Altman (1968) there has been considerable interest in using financial ratios for predicting financial distress in companies. Using univariate analysis, Beaver concluded that Cash Earnings to Total Debt was the best ratio for signalling bankruptcy and Altman (1968, 1977) pioneered the use of multiple discriminant analysis in predicting bankruptcy. Since then, discriminant analysis has become a standard approach for predicting financial distress. However, it has been criticised due to its restrictive assumptions (Eisenbeis, 1977; Altman and Eisenbeis, 1978; Scott, 1978; Karels and Prakash, 1987) as it requires a linear separation between the distressed and healthy firms and the ratios are treated as independent variables.

Non-linear models, such as the logit (Martin, 1977; Zavgren, 1985) and the probit (Amemiya and Powell, 1983), were used not only for classification but also for estimating the probability of bankruptcy (McFadden 1976; Press and Wilson, 1978; Ohlson, 1980 and Lo, 1986). However, these models also contain several limitations. First the choice of the regression function is a strong bias that restricts the outcome. Second, these methods are very sensitive to exceptions, which are very common in bankruptcy prediction with atypical firms seriously compromising the predictions. Third, most of the conclusions, like the confidence intervals, have an implicit Gaussian distribution, which does not hold for many cases. Although these methods may achieve low errors on the training data, they perform badly on generalization.

Non-parametric models (Stein e Ziegler, 1984 and Srinivasan and Kim, 1987) or linear programming (Gupta, Rao and Bagchi, 1990) have also been applied for bankruptcy classification, while a more recent avenue of research is the use of neural networks. Marose (1990), Barker (1990) and Berry and Trigueiros (1990) show that neural network is a complementary tool for the credit risk classification problem. Udo (1993) and Tsukuda and Baba (1994) show a higher overall efficiency of artificial neural networks (ANN). However, they did not present any statistical test for the predicted accuracy. Several authors (Coats and Fant, 1993; Wilson and Sharda, 1994; Yang, 1999; Tan and Dihadjo, 2001) found that ANN is a promising and robust technique that outperforms discriminant analysis in bankruptcy prediction. Results are however not conclusive as Altman, Marco and Varetto (1994) conclude that neural networks have lower generalization capability compared with traditional discriminant analysis, even if they are more effective at the end of learning cycle. All authors agree on the need for further research on new network topologies, training algorithms, learning methods, and combining techniques to achieve higher predictive capabilities.

In this work we present a modification of a recent neural network method, Hidden Layer Learning Vector Quantization (HLVQ), and analyze its efficiency against traditional neural network methods and discriminant analysis models, using a sample of French companies. This database is larger than most used in previous studies, which is a factor for improving the results.

The next section describes artificial neural networks in general and Section 3 presents the HLVQ method and how it is used to correct the output of a multilayer perceptron. Section 4 discusses the methods used for assessing the predictive capabilities of neural network and introduces a modification of the performance measure to evaluate the efficiency of early warning models proposed by Korobow and Sthur (1985). This section also describes the methods and criteria used on the multiple discriminant analysis that serves as a benchmarking for efficiency of ANN in general,

and HLVQ in particular, for the classification of the sample firms. Section 5 describes the data used in the research, Section 6 presents the results, and finally Section 7 contains the conclusions.

2. Artificial Neural Networks

Artificial Neural Networks (ANN's) are a set of algorithms inspired by the human brain's distributed architectures and parallel processing capabilities. ANN's are essentially multiple regression machines capable of learning directly from examples, requiring almost no prior knowledge of the problem. Data classification can be considered a regression problem, finding a function that maps an input into the corresponding class that minimises the misclassification rate. ANN's have intrinsic non-linear regression capabilities that make them highly competitive on difficult classification problems (Bishop, 1996).

The main advantage of ANN for the analyst is the reduction in unnecessary specification of the functional relation between variables. They are connectionist-learning machines where knowledge is imbedded in a set of weights connecting arrays of simple processing nodes called neurons. While ANN requires little knowledge of the problem, it is crucial to have large sets of "good quality" examples to properly train the network, i.e., representative and error-free data.

Classification of high dimensional data is a difficult task for statistical techniques, and for ANN as well, due to the well-known curse of dimensionality. The cause of this problem is due to data sparseness as the dimensionality of search space increases. If, for instance, a data point is characterized by 10 variables, each quantized in 10 states, the number of possible configurations of the input state is 10^{10} and a large set of training data will be necessary to cover this huge search space. Every time a new variable is added, the size of the search space grows by a factor of ten. Of course this

is a pessimistic estimate as most variables are correlated and the regression functions are smooth enough so that a reasonable estimate can be achieved from few points.

In general, training a network requires very large data samples, which may be difficult to obtain for the bankruptcy problem. For the bankruptcy prediction problem it is dubious to extract conclusions from a neural network trained with one or two hundred observations, as was reported by some authors previous mentioned in the literature review. As a rule of thumb the neural network should have a number of connection weights not much higher than 1/10 of the sample size available for training. In this work we use between 1 000 and 2 000 cases corresponding to 100 and 200 weights.

Learning can be either supervised or unsupervised. Although the former is always preferable, sometimes the latter is used as a clustering algorithm to reduce the complexity of the problem. In neural networks supervised learning is usually performed by Multi-Layer Preceptrons (MLP) with a single hidden layer. The most common method of training is back-propagation with a momentum term. Although other training algorithms are available, in most situations the results are hardly distinguishable.

The error function used is the Sum of Square Error (SSE):

$$E = \frac{1}{2} \sum_n (t^n - y^n)^2$$

where t^n are the target values (0 or 1) and y^n the actual outputs of the network. The unipolar activation function was used for the output.

Interpretation of the ANN output

Data classification is based on a winner-take-all strategy applying the following criteria to the neural network output:

$$\begin{cases} y > 0.5 \rightarrow y = 1 \\ y < 0.5 \rightarrow y = 0 \end{cases}$$

where 1 means a bankrupted and 0 a healthy firm.

There are two types of errors in classification problems. Type I error is the number of cases classified as healthy when they are observed to be bankrupted (N_{10}), divided by the number of bankrupted companies (N_1):

$$e_I = \frac{N_{10}}{N_1}. \quad (1)$$

Type II error is the number of companies classified as bankrupted when they are observed to be healthy (N_{01}), divided by the total number of healthy (N_0):

$$e_{II} = \frac{N_{01}}{N_0}. \quad (2)$$

If the output node has a sigmoid transfer function and the error function is the sum of square errors, the output of the neural network can be directly assigned to a membership probability (Bishop, 1996). Note however, that this interpretation is only valid in the context of an infinite number of training data. In general the outputs of the neural network cannot be used as a reliable estimator of the true class membership probability, particularly when data is scarce.

3. HLVQ – Hidden Layer Vector Quantization

In classification problems, when categories are too similar, both Learning Vector Quantization (LVQ) and Multi Layer Perceptrons (MLP) have weak performance (Michie et al., 1994). The Hidden Layer Learning Vector Quantization (HLVQ) algorithm was recently proposed to address this problem (Vieira and Barradas, 2003). In this method LVQ is applied to the hidden layer of a MLP, thus combining the merits of both approaches. HLVQ is particularly suitable for classification of high dimensional data.

The method is implemented in three steps. First, a specific MLP for the problem at hand is trained. Second, supervised Learning Vector Quantization is applied to

extract code-vectors \vec{w}_{c_i} corresponding to each class c_i in which data are to be classified. These code-vectors are built using the outputs of the last hidden layer of the trained MLP. Each example, \vec{x}_i , is classified as belonging to the class c_k with the smallest Euclidian distance to the respective code-vector:

$$k = \min_j \left\| \vec{w}_{c_j} - \vec{h}(\vec{x}) \right\| \quad (3)$$

where h is the output of the hidden layer and $\|\cdot\|$ denotes the usual Euclidian distance.

The third step consists of retraining the MLP with two important differences. First the error correction is applied not to the output layer but directly to the last hidden layer, thus ignoring from now on the output layer. The second difference is that the error applied is a function of the difference between $\vec{h}(\vec{x})$ and the code-vector, \vec{w}_{c_k} , of the respective class c_k to which the input pattern \vec{x} belongs. We used the generalized error function:

$$E_1 = \frac{1}{\beta} \sum_i \left(\vec{w}_{c_k} - \vec{h}(\vec{x}_i) \right)^\beta \quad (4)$$

The parameter β may be set to small values to reduce the contribution of outliers.

After training a new set of code-vectors,

$$\vec{w}_{c_i}^{new} = \vec{w}_{c_i} + \Delta \vec{w}_{c_i} \quad (5)$$

is obtained according to the following training scheme:

$$\begin{aligned} \Delta \vec{w}_{c_i} &= \alpha(t)(\vec{x} - \vec{w}_{c_i}) \text{ if } \vec{x} \in \text{class } c_i, \\ \Delta \vec{w}_{c_i} &= 0 \quad \text{if } \vec{x} \notin \text{class } c_i \end{aligned} \quad (6)$$

The parameter $\alpha(t)$ is the learning rate, which should decrease with iteration t to guarantee convergence. Steps two and three are repeated following an iterative

process. The method stops when a minimum classification error is found on the test set.

The distance of given example x to each class prototype is obtained by:

$$d_i = \left\| \vec{h}(x) - \vec{w}_{c_i} \right\| \quad (7)$$

HLVQ was applied with success in classification problems with high dimensional data, like Rutherford BackScattering data analysis (Vieira and Barradas, 2003).

MLP output correction using HLVQ

One of the major drawbacks of MLP's is their poor out-of-sample performance in regions not covered by the training data, particularly frequent in high dimensional data. In order to alleviate this situation we propose the following method to correct the MLP output for out-of-sample or test set data.

Each example to be tested, x^i , is included in the training set and the neural network retrained. Since the real situation of the company is unknown, we first consider it as class 0 (healthy) and determine the corresponding output $y_0(\vec{x}^i) = y_0^i$ as well as the respective distances to each class prototype obtained by HLVQ,

$$\vec{d}_0^i = (d_0^{c0}, d_0^{c1}) = (\|h_0(\vec{x}^i) - w_{c0}\|, \|h_0(\vec{x}^i) - w_{c1}\|) \quad (8)$$

Then the network is retrained considering now the test example as class 1 (bankrupted). The new output $y_1(\vec{x}^i) = y_1^i$ and the respective distances to the prototypes are then obtained:

$$\vec{d}_1^i = (d_1^{c0}, d_1^{c1}) = (\|h_1(\vec{x}^i) - w_{c0}\|, \|h_1(\vec{x}^i) - w_{c1}\|). \quad (9)$$

The correct output is chosen following a heuristic rule:

$$y^i = y_0^i \text{ if } d_0^{c0} < d_0^{c1}$$

$$y^i = y_1^i \text{ if } d_1^{c1} < d_1^{c0}.$$

We call this method HLVQ-C. If the example is a clearly bankrupted or healthy company the neural network output is a value close to 1 or to 0, respectively and in both cases the correction applied after retraining is small. However, when the output is close to 0.5 large corrections may occur. The most important corrections to the MLP output correspond to companies with uncommon financial records for which the training set contains few similar situations. Through a detailed analysis we found that the majority of corrections are consistent with the most relevant ratios.

4. Assessment of predictive capabilities of ANN

The quality of a neural network is measured by its generalization capability and robustness. To avoid the serious problem of over-fitting and validate the results of the network on the out-of-sample data, several procedures were implemented.

Weight averaging

As training evolves, the network weights converge to a set of values that minimizes the classification error. However, if data is insufficient to encompass the weights, oscillations may occur and the training may stop in a local minimum. To circumvent this problem, instead of using the final set of weights, we used the average of the last 5 best training epochs. This simple procedure proved to be effective to avoid errors on the test set due to the presence of uncharacteristic cases, i.e., companies with a set of parameters very different from the average of their classes.

Generalization

Generalization is a measure of the performance of the network on unobserved cases. The generalization capability of a neural network is often estimated by separating the dataset into two groups: a training set and a test set. The network is trained with data from the training set and its performance tested on unused data from the test set. Overfitting is avoided by stopping the training upon reaching a minimum error on the test set.

Although for large datasets this procedure is adequate, when data is scarce the test set may not be representative. In these cases, the most adequate procedure to evaluate the generalization capabilities of the network is to use ten fold cross validation. This consists of dividing the dataset into ten sets (A_1, \dots, A_{10}), using nine of them (A_2, \dots, A_{10}) for training and the remaining A_1 for testing. When training is completed the test error e_1 is recorded, and the process is repeated: train with (A_1, A_3, \dots, A_{10}), test with A_2 and record test error e_2 . After completion of the ten cycles, the generalization error, or cross validation error, e_{CV} , is calculated as the average of test set errors:

$$e_{CV} = \sum_{i=1}^{10} e_i / 10 \quad (10)$$

Note that the test set error is defined as:

$$e_i = \frac{N_{01} + N_{10}}{N_1 + N_0} \quad (11)$$

This estimation of the generalization capabilities of the network is unbiased.

Sensitivity

In highly dimensional data some variables have little or no discriminatory capabilities or may be strongly correlated. These variables should not be included in order to reduce the complexity of the problem and improve the generalization capabilities of the network. To detect some of these variables we compute the sensitivity defined as:

$$S_i = \frac{1}{N} \sum_{j=1}^N \frac{y(x_1^j, x_2^j, \dots, x_i^j + \Delta\epsilon_i, \dots, x_N^j) - y(x_1^j, x_2^j, \dots, x_i^j, \dots, x_N^j)}{\Delta\epsilon_i} \quad (12)$$

where the sum is over each j point of the database \vec{x}^j , and $\Delta\epsilon_i = 0.1\sigma_i$ is the perturbation introduced as 10% of the corresponding standard deviation. Variables with small S are eliminated.

A similar quantity to measure the stability of the result when noise is added to the output is the robustness, defined as:

$$R = \frac{y(x|t) - y(x|t + \delta)}{\delta} \quad (13)$$

where $y(x|t)$ is the output given the input x and a target t , and δ is a small quantity.

Benchmarking

In order to benchmark the predictive capabilities of our neural network model we compare it with traditional neural networks and discriminant analysis.

The linear discriminant function was obtained applying a stepwise method using a Wilk's Lambda and F value of 3.84 for entry variables and 2.71 for their removal. After the selection of variables we chose the five best discriminators and ran a Multiple Discriminant Analysis (MDA) with a leave one out classification. We also used the direct method with the 5 variables of the Altman (1968) Z-score model. We decided to use only five of the eleven ratios selected by the stepwise method, as the remaining six variables offered negligible incremental gains.

A typical problem of classification models in bankruptcy prediction is the unbalanced number of distressed firms compared with healthy firms. The use of balanced samples is common to overcome this problem. Wilson and Sharda (1994) studied three samples with variable proportions of healthy / bankrupted cases: 50/50, 80/20 and 90/10. They concluded that neural networks outperformed discriminant analysis in overall classification but did not analyze the effect of type I error and type II error in the overall classification efficiency.

A type I error in credit analysis implies a loss of capital loans and interest associated with a client that goes bust, when it was predicted to be healthy. Type II error leads to a loss of business with an existing or potential healthy customer that was classified as risky. Consequently, type I error may have higher costs for banks than type II error, as supported by Altman et al. (1977) who found that costs of type I error were 35 times higher for banks than error type II. This is not the same for other market players. For example, Neves and Andrade (1999) found for the Portuguese Social Security that the creation of a public earlier warning system, would have higher error type II costs for the economy as a whole than error type I, which led to the abortion of implementation of such a system. If a healthy company was classified and publicly announced to be at risk of bankruptcy, it would give a wrong signal for the market, that may induce a disruption in the economic relationships of the firm with its suppliers and customers thus pushing the firm further into a financial distress situation. Unfortunately misclassification costs are not sufficiently documented in the literature of financial distress and they remain largely unknown. As a consequence, we cannot use this perspective to analyze the efficiency of the classification models.

A common measure of the classification performance is the overall percentage of observations correctly classified - Equation 11. However, this measure is not adequate to evaluate the efficiency of classification since it blends the two types of errors. For instance, if for a sample of 70 healthy firms and 30 distressed firms the

model classifies all firms as healthy, the overall classification would be 70%, despite the fact that it was unable to identify one single bankruptcy.

We will use a Weighted Efficiency measure that takes into consideration the two error types, independent of cost to the creditor, defined by:

$$WE = \sqrt{OC \cdot BC \cdot BPC} . \quad (14)$$

The OC is the Overall Classification defined as

$$OC = \frac{N_{00} + N_{11}}{N_0 + N_1} \quad (15)$$

where N_0 is the total number healthy companies, N_1 the total number bankrupt companies, N_{00} is the number of healthy companies correctly classified and N_{11} the number of distress companies correctly classified.

The BC is the Bankruptcy Classification, i.e. the percentage of bankrupted firms correctly classified:

$$BC = \frac{N_{11}}{N_1} \quad (16)$$

BPC is the Bankruptcy Prediction Classification defined as the number of bankrupted firms to the total of predicted bankruptcies:

$$BPC = \frac{N_{11}}{N_{01} + N_{11}} \quad (17)$$

where N_{01} is the number of healthy companies classified as bankrupt.

This is a modification of the measure of efficiency presented by Korobow and Stuhr (1985) and is sensitive not only to the overall classification but also to errors of type I and type II. For perfect classification all components are 1 and the efficiency is 100%. The square root was used since the three ratios were not independent.

Consider, for instance, a balanced database with type I error equal to type II and where N_{01} is small. In this case $N_1 = N_0 = N/2$ and $N_{11} = N_{00} = x$, thus

$$WE = \sqrt{\frac{2x}{N} \frac{x}{N/2} \frac{x}{x}} = \sqrt{\left(\frac{2x}{N}\right)^2} = \frac{2x}{N},$$

which is now a linear function of the error x/N .

5. Data and Sample

The sample was obtained from Diane, a database containing about 780,000 financial statements of French companies and their foreign subsidiaries. The initial sample consisted of financial ratios on 2,800 non-financial French companies, for the years of 1999 and 2000, with at least 35 employees. From these companies, 311 were declared bankrupt in year 2000 and 272 presented a restructuring plan ("Plan de redressement") to the court for creditors approval. We decided not to distinguish these two categories as both signal companies in financial distress. As a consequence the sample has 583 financial distressed firms, most of them small to medium size, from 35 to 400 employees.

The inputs used in this study are presented in Table 1, consisting of 30 financial ratios published by Coface¹, which are available from Diane database.

(Table 1)

¹ Coface is a credit risk provider in France that offers the Conan-Holder bankruptcy score, a score based on a discriminant analysis developed by the authors (CONAN D., HOLDER M., 1979).

Additionally we consider the ratio of Cash Earnings to Total Debt that Beaver (1966) found to be the best single discriminator of bankruptcy, the 5 ratios used by Altman (1968) in his Z-score model, which is a standard in bankruptcy, and the size, measured by the logarithm of sales assuming that smaller firms may be more prone to bankruptcy than larger firms.

For cases of negative equity, the return on equity could not be calculated and a negative return of 150 percent was used instead.

As the number of healthier firms is higher than financially distressed, we randomly excluded some healthier cases in order to get the following ratios of bankrupted to healthy firms: 50/50, 36/64 and 28/72. It is known that lower ratios put stronger bias towards healthy firms, deteriorating the generalization capabilities of the network and increasing type II error.

Input selection

The number of inputs considered in this work is much larger than those used in previous works, which usually employ no more than ten variables. Although some of these inputs have small discriminatory capability in linear models, our neural network method is capable of extracting information and improving the classification accuracy without compromising generalization.

To select the inputs we used two procedures: elimination of highly correlated ratios and ratios with small sensitivities, or with a wrong sign according to economic analysis. We eliminated thirteen inputs (4, 6, 8, 9, 14, 16, 17, 22, 26, 27, 28, 29 and 30) described in Table 1 and retained the remaining seventeen.

In many cases, some ratios present high variance from one year to another, especially when firms are in financial distress. As a consequence, it is hard to predict bankruptcy based on single year information. In order to include relevant knowledge

from a previous year, without overloading the neural network input with excessive dimension, we decided to include one-year incremental absolute value of the following ratios: Debt Ratio, Percentage of Value Added to Employees and the Margin Before Extra Items and Taxes (or Ordinary Margin). Thus we end up with a complete set of 20 inputs.

All inputs were normalized in the usual way

$$x'^k = \frac{x^k - \mu^k}{\sigma^k}$$

where μ^k is the mean and σ^k is the standard deviation of input element k .

6. Results

We tested several neural networks using from 5 to 20 hidden nodes. Although smaller networks achieve slightly lower generalization errors, HLVQ-C performs better on a hidden layer of a large size. Then, we chose a hidden layer of 15 neurons, a learning rate of 0.1, and a momentum term of 0.25. For the HLVQ method we set $\beta = 1.5$.

Some firms in the database have a financial record that clearly contradicts their actual financial status. For these evident cases, we decided to artificially invert their output state. Companies with negative equity were always assigned to financial distress category, independently of their originally category. Although this accounts for less than 3% of bankruptcies some improvements were achieved on the training and testing error.

Table 2 shows the results obtained on balanced and unbalanced data sets for the year 1999, approximately one year prior to the announcement of bankruptcy. The training error is considerably smaller than the generalization error indicating that training data is insufficient. As expected, type II error is higher than type I error since distressed companies are more heterogeneous and harder to identify. Our study clearly

indicates that it is not advisable to use unbalanced samples since type II error increases considerably while type I error has only a slight improvement.

(Table 2)

In Table 3 we compare the weighted efficiency obtained by each of the four methods. Balanced samples are more appropriate for all the classification methods used while our method (HLVQ-C), clearly outperforms all others including discriminant analysis and non-corrected MLP (traditional ANN) for all types of samples. Discriminant analysis drops more in efficiency with unbalanced samples than neural networks. HLVQ-C is the technique that shows lower losses.

(Table 3)

We repeated the analysis for 1998, which is approximately two years prior to the bankruptcy announcement (Table 4). As expected all models show less predictive power than one year prior to the financial distress announcement. Concerning the use of unbalanced databases the same conclusions as 1999 apply.

(Table 4)

Again HLVQ-C performs much better than traditional neural networks – Table 5. Moreover the difference between traditional neural networks and discriminant analysis for balanced samples does not look significant.

(Table 5)

HLVQ-C also performs better for error I using balanced samples (Table 6). For unbalanced samples, both neural networks have a better performance but present worse type I errors. This indicates that they are less biased than discriminant analysis on unbalanced samples with too many healthy cases.

(Table 6)

We also compared the efficiency of the Neural Network with the five ratios used in the discriminant model (Debt Ratio, Logarithm of Sales, Value Added per Employee, Cumulated Depreciation Ratio and Return on Assets), with a neural network of only 5 hidden nodes – Table 7. The generalization error, as expected, is slightly higher than with the full 20 inputs. However, HLVQ-C was unable to correct efficiently these errors since it does not have enough degrees of freedom.

(Table 7)

Sensitivity analysis from neural networks shows that the most significant ratios for driving a company to financial distress (positive sensitivities) are: Debt Ratio, Percentage of Value Added for Employees and one-year absolute variation of the Debt Ratio. The most relevant ratios to characterize a healthy company (negative sensitivities) are: Valued Added per Employee, Margin Before Extra Items and Taxes and Cumulated Earnings to Assets.

7. Conclusions

We have applied neural networks to the problem of bankruptcy prediction using a new technique to correct the generalization errors, called HLVQ-C. In contrast with discriminant analysis and traditional neural networks, this technique allows the use of larger set of inputs without compromising generalization.

A modified measure of classification efficiency used by Korobow and Stuhr (1985) was introduced to evaluate the performance of the method. We found that HLVQ-C is the more efficient for this problem and clearly outperforms linear

discriminant analysis and traditional MLP in detecting distressed companies both one and two years prior to bankruptcy.

We also studied the effect of unbalanced samples and found that the best performance is obtained with a balanced dataset containing the same number of healthy and distressed companies. Unbalanced database should be avoided as type I errors, which have higher costs for banks, may be too high.

These results could eventually be improved if we had the identification of the industrial sector for each company, as some ratios may only be meaningful for some sectors.

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Table 1: Mean values and standard deviation of all indicators for bankrupt and healthy companies in the year of 1999

Ratio	Definition	Bankrupted	Healthy
		\bar{x}_i, σ_i	\bar{x}_i, σ_i
1	Number of employees	55.3, 82.0	86.2, 157.3
2	Financial equilibrium ratio	1.2, 2.1	1.4, 2.2
3	Equity to Stable Funds	19.9, 27.1	39.4, 19.3
4	Debt to Stable Funds	18.9, 77.3	10.8, 13.0
5	Financial autonomy	13.3, 32.4	37.6, 19.8
6	Cumulated depreciation rate (%)	69.4, 19.6	70.3, 14.5
7	Current ratio	1.1, 0.6	1.6, 1.4
8	Quick ratio	0.8, 0.5	1.2, 1.3
9	Inventory days of sales	45.5, 66.8	45, 66.5
10	Collection period	56.0, 42.6	75, 32.8
11	Interest to sales (%)	1.2, 5.3	0.8, 2.8
12	Debt ratio	83.2, 32.3	59.0, 18.9
13	Financial Debt to Cash earnings	6.5, 111.3	6.6, 119.1
14	Cash earnings to sales (%)	2.1, 13.0	4.4, 6.7
15	Working capital in sales days	20.4, 76.5	64.5, 86.3
16	Working capital requirements in sales days	16.1, 76.2	50.6, 70.2
17	Exportation (%)	3.9, 24.2	9.0, 21.1
18	Value added per employee	32.3, 15.3	44.6, 29.05
19	Value added to assets	0.5, 49.7	0.4, 0.2
20	EBITDA margin	3.3, 13.5	6.8, 7.6
21	Margin before extra items and taxes	0.3, 2.54	3.2, 3.4
22	Net margin	0.5, 18.6	1.2, 7.8
23	Return on equity	-11.4, 116.3	8.9, 38.4
24	Value added margin	41.2, 19.5	38.3, 15.6
25	Percentage of value added to employees	86.1, 103.8	75.7, 35.2
26	Sales (kEuro)	9093, 17350	25217, 40412
27	Working capital to current assets	0.04, 0.53	0.36, 0.27
28	Payment period	89.0, 120.3	76.9, 31.4
29	Debt in sales days	208.4, 192.2	145.8, 76.3
30	Return on equity before extra items & taxes	-36.1, 137.4	21.4, 54.7

Table 2: Results for a set of balanced and unbalanced data for the year of 1999. HLVQ-C means the output of the MLP are corrected by the method using HLVQ distances.

Bankrupt / Healthy	Training error		Generalization error	
	Type I error	Type II error	Type I error	Type II error
50/50				
MLP	10.6	15.9	13.1	25.7
HLVQ-C	8.2	10.1	10.6	11.1
36/64				
MLP	4.6	13.8	8.8	30.9
HLVQ-C	2.1	5.8	7.3	18.7
28/72				
MLP	2.6	14.2	7.1	35.8
HLVQ-C	1.8	11.2	6.3	29.0

Table 3: Weighted efficiency for the year of 1999

Sample:	50/50	36/64	28/72
Discriminant:			
Best discriminant variables	66.1%	60.2%	59.3%
Z-score variables	62.7%	52.1%	47.5%
Neural Networks:			
MLP	71.4%	68.5%	65.0%
HLVQ-C	84.1%	78.9%	71.0%

Table 4: Weighted efficiency for the year of 1998

Sample:	50/50	36/64	28/72
Discriminant:			
Best discriminant variables	66.4%	59.5%	47.3%
Z-score variables	61.1%	50.9%	32.0%
Neural Networks:			
Traditional	67.7%	69.5%	60.1%
HLVQ-C	76.5%	74.3%	69.5%

Table 5 – Type error II for unbalanced samples

	Sample 50/50		Sample 36/64		Sample 28/72	
	1998	1999	1998	1999	1998	1999
Discriminant:						
Best discriminant variables	24.9%	26.4%	44.5%	44.6%	68.4%	51.5%
Z-score variables	31.6%	26.8%	57.1%	54.5%	83.2%	66.0%
Neural Networks:						
Traditional	24.9%	25.7%	30.9%	30.9%	44.9%	35.8%
HLVQ-C	16.0%	11.1%	16.0%	18.7%	27.8%	29.0%

Table 6 - Type error I for unbalanced samples

	Sample 50/50		Sample 36/64		Sample 28/72	
	1998	1999	1998	1999	1998	1999
Discriminant:						
Best discriminant variables	22.4%	21.0%	7.6%	6.8%	1.5%	2.9%
Z-score variables	22.8%	26.8%	6.1%	7.0%	1.3%	2.6%
Neural Networks:						
Traditional	20.2%	13.1%	7.9%	8.8%	5.8%	7.1%
HLVQ-C	16.8%	10.6%	12.8%	7.3%	8.2%	6.3%

Table 7: Neural Networks trained with the five inputs chosen by the discriminant analysis, in the year 1999 using the balanced database.

	Training error		Generalization error	
	Type I error	Type II error	Type I error	Type II error
MLP	15.6	20.1	17.1	25.3
HLVQ-C	10.5	14.3	14.8	23.7